



# The Federal Report

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

## The Month in Washington: April 2006

### Majority, White House, Make Pre-Election Adjustments

Confronting ties to an unpopular president whose poll numbers continue to worsen, the Republican majorities in the House and Senate are preparing a health care, economic, and social agenda to present to voters in the fall. For its part, the White House made personnel changes, moving political mastermind Karl Rove from a policy to more of a campaign position, selecting a new Chief of Staff, and elevating a friend of the pension community to head the Office of Management and Budget (OMB).

The White House dispatched Karl Rove from his policy position at the White House to the field for political work on the coming elections. The move signals not only the attention which the President pays to the alarming approval ratings but also a tacit admission that there is essentially no substantial new policy work that can be done in the time remaining before voters take to the polls. In another move seen favorably by legislators, public plans, tax experts, budget-cutters, and free-traders, the Administration promoted former Ohio Congressman Rob Portman (R) from U.S. Trade Representative to Director of the OMB, which assembles the President's budget proposals. The affable and respected Portman brings a reputation for mastery of tax issues, including pensions, and willingness to work hard across party lines.

Meanwhile, up on Capitol Hill, Congressional Republicans are scrambling to respond to recent polls that find that only 20% of those surveyed "strongly approve" of the President's performance while 47% "strongly disapprove." Because pollsters have established that intensity of feeling generates turnout on Election Day, the new numbers indicate that those most motivated to vote dislike the President by two and a half to one, predicting bad news for the President's allies in Congress.

Congressional leaders moved to counter these worrisome trends by returning to an agenda favored by their base of conservative voters. A leading trade periodical reported that the GOP would move legislation requiring votes on tax cuts, gay marriage, and flag burning as a way to remind their core constituents that the incumbent lawmakers share their moral and economic visions. Senate Minority Leader Harry Reid (D-NV) took to the Senate floor on April 24, 2006, to denounce the schedule proposed by the Majority, the "do-nothing" record of this Congress, and the tendency, in his eyes, to ignore real issues of importance to the American people.

In addition, GOP Members said they would tout their health accomplishments by stressing the value of the Medicare prescription drug benefit and proceed on a bill to encourage formation of small business health plans. A medical malpractice reform bill, S.4, could also come to the Senate floor to appeal to conservative voters with calls for tort reform and limited medical liability.

Sources suggest that the prospects for the legislation to come is not necessarily positive but that actual enactment of bills into law is a secondary consideration compared to showing core Republican voters that their Members of Congress are committed to their agenda. Almost always, appealing to the ideological base means alienating the ideological middle, decreasing the chances of compromise needed to pass bills. Given this strategy by the majority, it would be surprising if the minority became willing to cut them any breaks for the sake of legislative progress on an election-based agenda.

Every day that passes brings the election closer and diminishes motivation to compromise. An early start to election year trench warfare means that items of interest to the public sector such as the pension reform bill (in conference) or immigration reform (in limbo on the Senate floor) face even more of an uphill battle as the focus shifts from lawmaking to campaigning.

## **Issues and Events**

### **First Mention of Scraping Pension Conference as Tax Leaders Regroup**

Tax committee conferees returned from Easter Recess with their two largest priorities remaining almost exactly where they were before the two-week break. The symbolic deadline of April 15 passed without agreement on their two main measures - reconciliation and pension reform - with the former measure hung up on the way in which to pay for its package of capital gains and Alternative Minimum Tax relief.

Perhaps not surprisingly, reports are beginning to show up in the media of the possibility of junking the pension conference entirely. Should the next deadline of Memorial Day come and go without an agreement, "all bets are off," according to an unnamed GOP Senate aide. These reports were confirmed with several calls to the Hill, where staff relayed a thorough mood of frustration with the lack of progress but retained enough optimism to hold onto hope for now. One senior aide said that the chance of bailing out on the conference now was a "two" on a scale of one to ten but that guess might change to a "seven" if there is not significant progress by Memorial Day. Also during the month, the House twice instructed conferees on a pair of controversial matters in the legislation. Instructing conferees is a floor vote where one chamber directs its negotiators to take a specific negotiating position in conference. While not a binding command for the House chamber's representatives to maintain throughout the meeting, it does provide them with a stronger negotiating position in meetings with their Senate counterparts.

The first issue addressed by a Motion to Instruct, funding requirements for private plans, lays at the very heart of the controversy over the bills and has largely powered whatever urgency lawmakers feel over pension reform, unlike the permanent extension of the EGTRRA changes for public funds carried in the Senate version of the bill. The House told its negotiators to argue for the lowest possible funding requirements on private plans which would shore up their solvency, believing that this position would provide the most incentive for private employers to maintain rather than terminate their DB plans. The second vote also favored the Senate, directing House conferees to accept the Senate position on cash balance conversions. Congressman George Miller (D-CA, Richmond) led the fight, prevailing 248-178, to adopt the Senate language which offered stronger and more specific protection for worker benefits accumulated before a transition away from a traditional defined benefit plan.

With frustration over the conference mounting, the public sector may want to begin bracing itself for the possibility that this Congress is simply unable to move pension reforms at this stage in the game. Even where both chambers agreed to their versions of the bill by significant margins, the viability of the pension conference keeps taking body blows.

### **FASB “Smoothing” Rule Joins Pension Conference Issues**

Propelled by studies that claim new pension accounting rules for the private sector will wreck havoc on balance sheets, the rule from the Financial Accounting Standards Board (FASB) entered the pension reform bill conference morass.

The FASB would require private concerns to report the actual, current funding status of their plans when they file their financial disclosures. Previously, companies were allowed to average their returns, and thus their funded status, over several years. In the post-Enron, post-WorldCom environment, critics claim that “smoothing” investment returns used to fund post-retirement benefits masks the true financial status of plans maintained by the employer.

Consultants Watson Wyatt released a report this month claiming that the FASB changes would cut shareholder equity in the Fortune 1000 by 10%. The actuarial firm Milliman found that, had the rule been in effect in 2005, the Fortune 100 would have lost \$222 billion off their bottom lines. Joining the fray, the American Academy of Actuaries wrote in a letter to FASB that the drastic negative effect these requirements will have on the reported numbers of public companies provides yet another reason for private employers to terminate their increasingly administratively complex and burdensome benefit plans.

The pension reform bill in conference could serve as a vehicle for a legislative remedy for the FASB smoothing proposal, providing that legislation does not collapse under the weight of the political calendar. As discussed previously, however, the conference already has a host of controversies within it that have slowed the progress of negotiations to an almost glacial pace. Perhaps the conference can be jump-started by the implied threat that new funding requirements in the pension bill and strict accounting treatment for benefit plans from the FASB will leave public companies no choice but to terminate their plans. Such a move by any significant number of sizable plans would push the Pension Benefit Guarantee Corporation even more deeply into insolvency, adding to the Federal government’s budget woes. Avoiding that result has been one of the chief motivators for pension reform legislation.

### **Public Sector Opposes GASB Proposal for Medicare Part D Transfers**

As politicians continue to fight over the future of the Medicare Part D drug benefit, plan experts must iron out its details, including the technical issues of accounting treatment. Public plans delivered their comments late this month on rules from the Government Accounting Standards Board (GASB) on various issues related to the new drug benefit.

The letter addresses two core weaknesses of the GASB draft. Under the proposal, the subsidy provided by Part D payments would not be an offset for Other Post Employment Benefit (OPEB) liabilities, which the letter notes would probably hasten the elimination of even more retiree healthcare plans by exaggerating their costs. The commenters assert that Congress included the subsidy in the new benefit exactly to prevent such incentives

for termination by lowering costs to taxpayers as employer obligations are lowered through the transfer. The private sector counterpart to GASB, the Financial Accounting Standards Board (FASB), treats reimbursements from Part D in the more favorable manner sought by public plans.

The public plan groups also faulted the GASB proposal for disallowing use of the Part D reimbursements as a “mitigating factor” in computing expected retiree health costs. Given the volatility in so many other factors used to predict future costs, the groups argue that one of the few sources of stability in the OPEB equation - the reimbursement - should certainly be included so that calculations can have some grounding in items that can be accurately predicted.

## **California Congressional Delegation**

### **Calvert to Appropriations?**

The announcement by former House Majority Leader Tom Delay (R-TX) that he would not seek reelection has started a push by California Congressional leaders to gain a seat on the powerful Appropriations Committee for one of its own. The leading figure to take the spot is Ken Calvert, a well-regarded Republican representing parts of Riverside and Orange counties since 1992.

The California Delegation pressed for Calvert to gain the Appropriations seat vacated by Representative Randy “Duke” Cunningham (R-CA, Escondido). Delay asserted his seniority to take the opening when it became available after Cunningham’s resignation, however. Now that Delay will also be departing before mid-June, the opening has appeared once more. Should Calvert get the prized assignment to Appropriations, he would join fellow Californians Jerry Lewis (R-Redlands), now Chairman of the Committee, John Doolittle (R-Granite Bay), Lucille Roybal-Allard (D-Los Angeles), and Sam Farr (D-Santa Cruz).

As the Ways and Means Committee determines where Federal money comes from, the Appropriations Committee decides where it goes. Almost all of the other Congressional committees simply define how money gets spent, not how much.

### **Miller Wins Another Pension Floor Vote**

On pension issues, Congressman George Miller (D-CA, Richmond) led another successful effort to instruct House negotiators on the pending pension reform bill in conference. As mentioned in the top story, Miller led the fight for the House to adopt the Senate position on cash balance conversion guidelines, preferring that approach to an uncomfortable silence on the issue found in the House bill. The American Association of Retired Persons took out a full page ad in the April 26, 2006, edition of *CQ Today* to support the Senate cash balance provisions.

A Motion to Instruct directs a chamber’s conferees to take one position or another of those available in the two bills in conference. While theoretically binding, the motion only tells conferees to begin at a certain negotiating position; they need not insist on that position for final agreement on the legislation.

At the end of last month, Miller also secured agreement from the House that any new funding requirements for private plans should be the minimum needed to boost solvency

rather than providing an incentive for termination. This approach to stronger funding for private plans seeks to improve private pension solvency without pressuring employers to terminate.

## **Related National and Industry News**

### **Two Different Approaches to Health Coverage from Senate, Massachusetts**

Senate Republican leaders have declared the week of May 1 to be “Health Week,” with the legislation by Senate Health, Education, Labor, and Pensions (HELP) Committee Chairman Michael Enzi (R-WY) taking center stage. Senator Enzi’s bill, S. 1955, allows small businesses to group together to purchase health coverage and makes the new policies more affordable by preempting almost every State requirement for health insurance policies. States would continue to monitor the plans and the Enzi bill requires that at least one plan offered by the new purchasing pool match the benefits offered to State employees in one of the five most populous States, perhaps an admission that public sector benefits remain standard-setting.

State and local government groups oppose the Enzi measure because of its nearly total preemption of State regulation of insurance. This month, the American Association of Retired Persons (AARP) announced its opposition to the bill as well, citing the potential harm to the existing insurance market and to their members within it. Several medical groups, fearful that certain conditions and ailments will be dropped from coverage, also oppose the measure.

CalPERS also opposes the Enzi legislation. Establishing new pools exempt from most regulation and mandated coverage could draw members from the System and harm the current risk pool. As part of a “race to the bottom” in coverage quality, having new policies without costly mandates and no limit on cost-sharing may pressure the System to offer similar packages with less benefits than offered now. Because the plans envisioned under the Enzi bill are also not required to community-rate, insurance providers would be free to “cherry-pick” the healthiest, lowest cost people into some plans and leave an older, sicker population in others, with those plans priced accordingly. When fully considered for their implications, these changes point to lower quality insurance and higher prices for all but the youngest and healthiest workers.

Back in the trenches, Massachusetts managed an impressive bipartisan agreement on health coverage, solving a puzzle that has thus far eluded other States or the Federal government. The new law mandates that every citizen of the State obtain health insurance by some means or face additional tax liability, with the State providing a graduated level of assistance for poorer residents. Governor Mitt Romney (R) vetoed a section of the measure requiring businesses with 11 or more workers to provide coverage or pay a \$295 surcharge, asserting that the potential \$45 million from the fee as unnecessary to fund the overhaul legislation.

The measure also includes a requirement for “reference pricing” of drugs. Business consultants Bain & Company explained in a press release reference pricing in general and other factors threaten to cost the pharmaceutical industry \$30-35 billion over three to four years. Reference pricing forces purchasers to select the cheapest drug available among products which do essentially the same thing, creating a hostile marketplace for what the release calls “me, too” drugs - treatments which are third or fourth to market which are

not demonstrably different from other alternatives already in circulation. The drug pricing practice is in use in Europe, where it has had some success in containing drug costs.

Approval of the Massachusetts plan makes the State eligible for \$385 million in Federal grants under a waiver between the Department of Health and Human Services and the State to develop means to cover the uninsured.

### **SOX Helps Boost Value Says HBR**

The April 2006 edition of Harvard Business Review (HBR) asserts that corporate management can use the Sarbanes-Oxley law (known as “SOX”) to discover and enhance value for the companies they run. Two experts from the Deloitte family of consulting firms authored the article.

After a difficult first year, compliance costs are down and the procedures mandated by SOX are becoming “a source of valuable insights into operations, which management has translated into improved efficiencies and cost savings.” The new law, particularly Section 404 which required an independent examination of internal accounting controls, provided a much needed excuse for some executives to devote more resources to examining their financial procedures not simply to avoid lawsuits and enforcement actions but to better understand how the company worked. Forcing top management to look at their internal safeguards revealed “lack of enforcement of existing policies, unnecessary complexity, clogged communications, and a feeble compliance culture,” according to the piece.

The Deloitte authors also note that SOX 404’s requirements for independent board members has produced a “substantial” change in board membership. Based on more frequent meetings and higher quality of questions being asked, the writers infer that “both recruits and veterans (of corporate boards) are taking their new responsibilities very seriously.”

SOX has forced top management to actually examine many of the processes which they presumed were working and, rather than becoming a costly and redundant mandate, has generated important findings of oversight, duplication, and inefficiency. These positive results are especially pronounced in firms where management approached the new law as an opportunity rather than a burden.